Consider a HECM Reverse Mortgage Now

by Gerald C. Wagner, Ph.D.

Jerry Wagner is President of Ibis Software, which specializes in reverse mortgages, and has been described by Ken Scholen, of the AARP, as "the sharpest analytical mind we've seen in this market." Wagner has a Ph.D. in Economics from Harvard University. His thesis titled "Portfolio Construction and Diversification" was written under John Lintner, one of the founders of Modern Portfolio Theory.

Executive Summary

- The most generous reverse mortgage program is the FHA's home equity conversion mortgage (HECM). The money available, called the Principal Limit, depends on the age of the youngest borrower, the value of the home, and the 10-year LIBOR swap rate.

- On June 27, 2014, the Principal Limit factors were changed making them more sensitive to swap rate increases and giving added benefits to older borrowers.

- In 84% of the most recent 152 weeks, the swap rate has been low enough to give borrowers the maximum Principal Limit available under the HECM program.

- If the swap rate rises 1.0% above its current level (from 2.66% to 3.66%), the money available to a 63-year-old will fall by 21%.

- One can just let the new HECM lay fallow. Its line-of-credit capacity will grow each month, and when funds are finally accessed they are tax-free loan advances.

- The cost of obtaining a HECM has been greatly reduced. Borrowers who have financial resources will pay only a 0.50% initial Mortgage Insurance Premium (more info below**).**

- In October 2013, the FHA reduced Principal Limits by 15%. Entering a HECM will guard against future changes in Principal Limits.

The next three pages each show a chart with a summary explanation. Detailed information begins on page 5.

The charts show why homeowners, age 62 or older, who have enough assets to engage a financial planner, should consider a HECM.

Even those without many assets other than their home should consider it. To qualify, the reverse mortgage proceeds, plus any money brought to the table, must be enough to pay off any existing mortgage.

Chart 1 shows the history of the LIBOR rates used with a HECM. It starts on July 10, 2000, which was the first week that the Fed published the 10-year swap rate. The latest rates shown are for the week of June 30, 2014.

Until the last few years, rates have been volatile. The Fed has been keeping rates artificially low, but they are now talking about backing off of that policy.

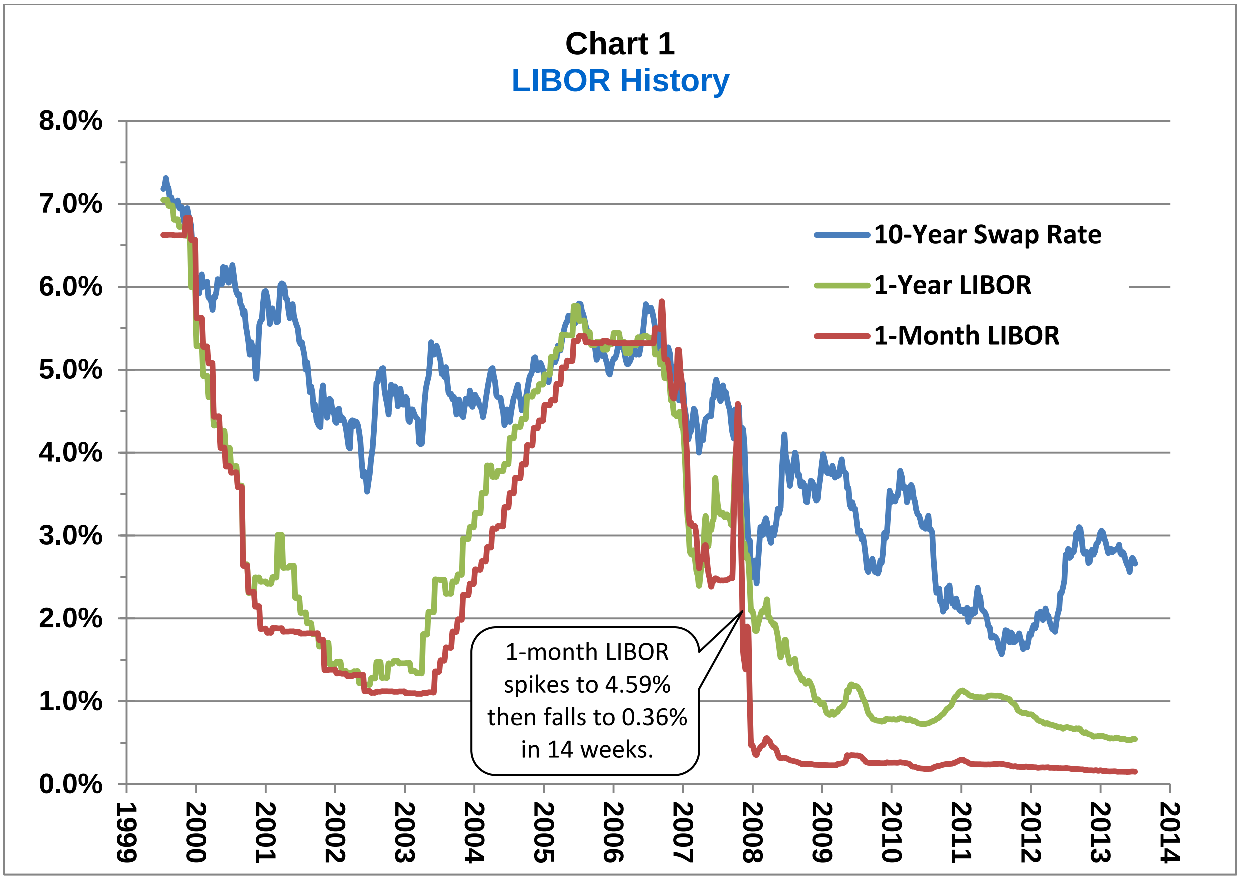


Chart 2 shows the Principal Limits available to a 63-year-old borrower that owns a $300,000 home. The calculations are for a monthly adjusting HECM with a 2.25% lender margin. Borrowers have enjoyed the maximum benefit in many weeks over the last three years. The values in the chart use the June 2014 Principal Limit factors.

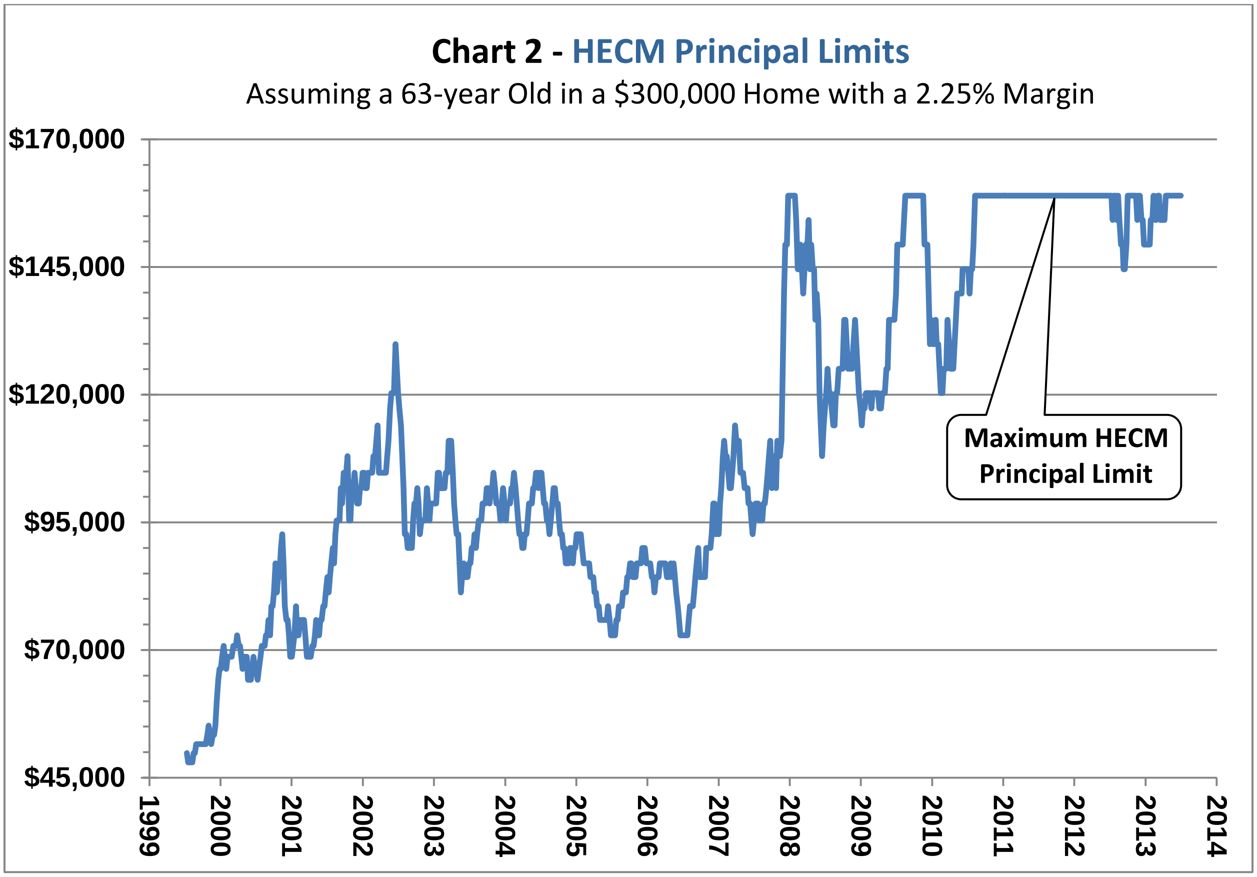
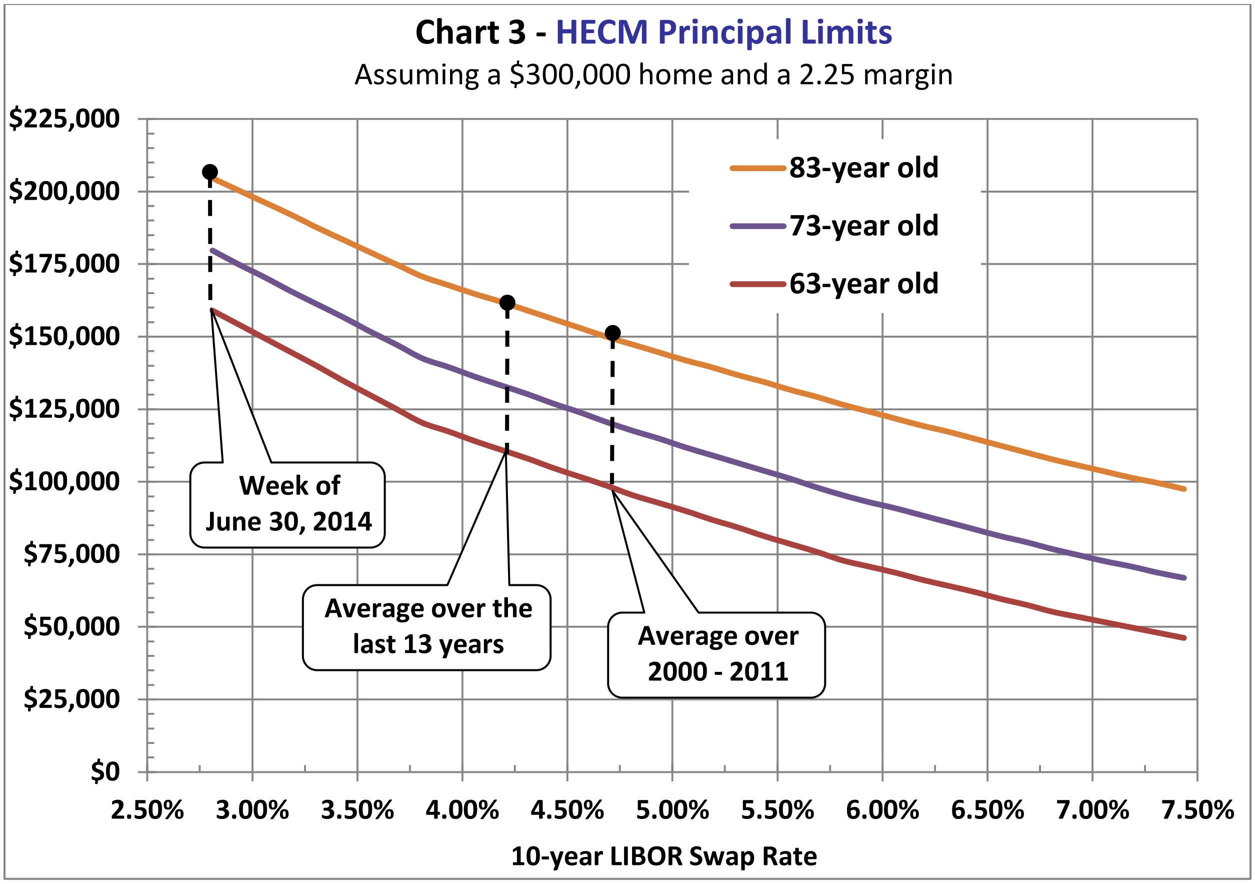


Chart 3 shows how borrowers of different ages will be affected by rising rates. If the 10-year swap rate goes up to its historic averages, benefits will be materially reduced. Chart 3 plots figures from Table 1 in the Appendix. The figures use the June 2014 Principal Limit factors.



Mortgage Insurance Premiums

The primary reverse mortgage program available today is the FHA's HECM. It comes with two levels of FHA initial Mortgage Insurance Premium (MIP). If draws in the first year will exceed 60% of the total funds available, the initial MIP is 2.50%. If draws in the first year are 60% or less, the initial MIP is only 0.50%. MIP is based on the home value (capped at the FHA lending limit, currently $625,500). On a $300,000 home, the MIP would be either $7,500 (2.50%) or $1,500 (0.50%). It is worthwhile to pay down existing liens to move below the 60% first-year draw threshold. That would eliminate $6,000 in MIP. After one year has passed, you can draw any pay downs back out of the HECM without incurring extra MIP.

Besides this initial MIP, a HECM accrues ongoing MIP at an annual rate of 1.25% of the outstanding loan balance. Imagine the initial MIP and the ongoing MIP going into a FHA reserve pool that allows a HECM to be a nonrecourse loan. This means that the borrower or their heirs will never owe more than the home is worth. Subject to certain FHA rules, the heirs can buy the home for 95% of its then current appraised value. For example, if in 15 years, the home is worth $400,000 and the HECM balance is $500,000, the heirs can buy the home for $380,000, and the FHA reserve pool would absorb the $120,000 shortfall.

HECM Interest Rates

There are two rates to consider: the Expected Rate and the Effective Rate. The Expected Rate is set at closing and never changes. It is the 10-year LIBOR swap rate plus the lender's margin. Throughout these notes, we assume that the lender's margin is 2.25%. HECM has a 120-day rate lock feature such that the swap rate used is the better of the one at application or at closing. So by applying for a HECM under present conditions, the maximum proceeds can be enjoyed even if rates rise materially over the 60 days it may take to close the loan. The Expected Rate is fixed for the life of the loan and is used for any future payment plan change calculations.

The HECM Principal Limit factor is found in a lookup table using the youngest borrower's age and the Expected Rate rounded to the nearest one-eighth percent subject to a lookup floor of 5%. As rounded Expected Rates increase, such as from 5.125% to 5.250%, Principal Limits fall. Because of the 5% floor, any Expected Rate of 5.06% or less gives the maximum Principal Limit. 5.06% rounds down to 5.00%, but 5.07% rounds up to 5.125% resulting in less money being available.

The Effective Rate is the chosen index plus the lender's margin (2.25% in this example) plus ongoing MIP (1.25%). There are two forms of adjusting rate LIBOR HECM's -- one adjusts monthly and the other adjusts annually. The index for the monthly adjusting HECM is the one-month LIBOR rate as published five weeks before the rate change. This allows loan servicers to notify borrowers in their monthly statements what the new rate will be. The monthly adjusting HECM generally has a lifetime cap increase of 10% above the initial rate. Historically the chances of reaching this cap are very low. Recently some lenders have been offering a monthly adjusting HECM with a 5% lifetime cap increase.

The annually adjusting HECM uses the one-year LIBOR rate as its index. It generally has a 2% cap on annual changes and a 5% lifetime cap. Lenders often charge a higher margin on annually adjusting HECM's than they do on monthly adjusting HECM's.

The initial Principal Limit grows each month at the Effective Rate divided by 12. At any point in the future, the line-of-credit capacity is the future Principal Limit less the then current loan balance less the future service fee set-aside, if any. This is a good feature. A monthly adjusting HECM's line-of-credit could grow at an annual rate of 3.65%; that's the 0.152% 1-month LIBOR index, plus the 2.25% lender's margin, plus 1.25% ongoing MIP. And, with a 1-year LIBOR index of 0.545%, an annually adjusting HECM line could grow at 4.05%. These growth rates are tax-free.

This means that a borrower with financial resources could pay down their HECM rather than put their money into a taxable, low yield CD. The HECM line-of-credit would grow tax-free until funds are needed. Withdrawals are considered loan advances and are tax-free. Unlike a traditional HELOC, a HECM line-of-credit cannot be reduced so long as the borrower meets the loan terms. Terms include that the home remain the principal residence and that property taxes and homeowner insurance premiums are timely paid.

Why consider a HECM now?

With a 2.25% lender margin, the highest 10-year swap rate that will give the maximum HECM benefits is 2.81%. Lower margins are available from some lenders, but even with a 2.00% margin, the highest 10-year swap rate could be 3.06% to give the maximum. The index and the margin must add up to 5.06% or less to give the maximum Principal Limit. In the week of June 30, 2014, the swap rate was 2.66%. This is not much leeway from 2.82%, where Principal Limits would fall a notch. When you apply for a HECM, there is a rate lock that is good for 120 days.

The two tables in the Appendix show how Principal Limits are affected by rising rates.

Here is a Bibliography of recent articles showing how a reverse mortgage can be a valuable retirement tool even for borrowers that have material resources. You can read my article and use the calculators at http://www.reversemortgagehomepage.com/Retirement.asp

Bibliography

Pfeiffer, Shaun, C. Angus Schaal, and John Salter. 2014. "HECM Reverse Mortgages: Now or Last Resort?" *Journal of Financial Planning* 27 (5) 44–51.

Pfeiffer, Shaun, John Salter, and Harold Evensky. 2013. "Increasing the Sustainable Withdrawal Rate Using the Standby Reverse Mortgage" *Journal of Financial Planning* 26 (12): 55-62.

Sacks, Barry H. and Stephen R. Sacks. 2012. "Reversing the Conventional Wisdom: Using Home Equity to Supplement Retirement Income" *Journal of Financial Planning* 25 (2): 43-52.

Salter, John, Shaun Pfeiffer, and Harold Evensky. 2012. "Standby Reverse Mortgages: A Risk Management Tool for Retirement Distributions" *Journal of Financial Planning* 25 (8): 40-48.

Wagner, Gerald C. 2013. "The 6.0 Percent Rule" *Journal of Financial Planning* 26 (12): 46-54.

Appendix Table 1 - Principal Limits Given Lookup Rates

Assuming a $300,000 home with a 2.25% margin

10-Year Swap Rate	Lookup Rate	Age 63	Age 68	Age 73	Age 78	Age 83	Age 88
2.81%	5.000%	$159,000	$168,600	$179,700	$192,000	$204,600	$218,700
2.94%	5.125%	$154,200	$164,100	$174,900	$187,500	$200,400	$214,800
3.06%	5.250%	$149,400	$159,300	$170,400	$183,000	$196,200	$210,900
3.19%	5.375%	$144,600	$154,500	$165,600	$178,500	$192,000	$207,000
3.31%	5.500%	$139,800	$149,700	$161,100	$174,000	$187,500	$203,100
3.44%	5.625%	$134,700	$144,900	$156,600	$169,500	$183,300	$199,200
3.56%	5.750%	$129,900	$140,400	$151,800	$165,000	$179,100	$195,300
3.69%	5.875%	$125,100	$135,600	$147,300	$160,500	$174,900	$191,400
3.81%	6.000%	$120,300	$130,800	$142,500	$156,000	$170,700	$187,500
3.94%	6.125%	$117,300	$127,500	$139,500	$153,000	$167,700	$184,500
4.06%	6.250%	$114,000	$124,500	$136,200	$149,700	$164,700	$181,800
4.19%	6.375%	$111,000	$121,200	$133,200	$146,700	$162,000	$179,100
4.31%	6.500%	$108,000	$118,200	$130,200	$143,700	$159,000	$176,400
4.44%	6.625%	$104,700	$114,900	$126,900	$140,700	$156,000	$173,700
4.56%	6.750%	$101,700	$111,900	$123,900	$137,400	$153,000	$171,000
4.69%	6.875%	$98,700	$108,600	$120,600	$134,400	$150,000	$168,300
4.81%	7.000%	$95,400	$105,300	$117,600	$131,400	$147,300	$165,600
4.94%	7.125%	$92,700	$102,600	$114,900	$128,700	$144,600	$163,200
5.06%	7.250%	$90,000	$99,900	$111,900	$126,000	$141,900	$160,800
5.19%	7.375%	$87,000	$97,200	$109,200	$123,300	$139,500	$158,400
5.31%	7.500%	$84,300	$94,500	$106,500	$120,600	$136,800	$155,700
5.44%	7.625%	$81,300	$91,800	$103,800	$118,200	$134,400	$153,300
5.56%	7.750%	$78,600	$89,100	$101,100	$115,500	$131,700	$150,900
5.69%	7.875%	$75,900	$86,400	$98,100	$112,800	$129,300	$148,500
5.81%	8.000%	$72,900	$83,400	$95,400	$110,100	$126,600	$146,100
5.94%	8.125%	$70,800	$81,300	$93,000	$107,700	$124,200	$143,700
6.06%	8.250%	$68,700	$78,900	$90,900	$105,300	$121,800	$141,300
6.19%	8.375%	$66,300	$76,500	$88,500	$102,900	$119,400	$139,200
6.31%	8.500%	$64,200	$74,100	$86,100	$100,500	$117,300	$136,800
6.44%	8.625%	$62,100	$72,000	$83,700	$98,100	$114,900	$134,400
6.56%	8.750%	$59,700	$69,600	$81,300	$95,700	$112,500	$132,000
6.69%	8.875%	$57,600	$67,200	$79,200	$93,300	$110,100	$129,600
6.81%	9.000%	$55,200	$64,800	$76,800	$90,900	$107,700	$127,500
6.94%	9.125%	$53,400	$63,000	$74,700	$89,100	$105,600	$125,400
7.06%	9.250%	$51,600	$61,200	$72,600	$87,000	$103,500	$123,300
7.19%	9.375%	$49,800	$59,400	$70,800	$84,900	$101,400	$121,200
7.31%	9.500%	$48,000	$57,300	$68,700	$82,800	$99,600	$119,100
7.44%	9.625%	$46,200	$55,500	$66,900	$80,700	$97,500	$117,000

Appendix Table 2 – Percentage Decline in Principal Limits as Rates Rise
Assuming a new monthly-adjusting HECM with a 2.25% margin

10-Year Swap Rate	Lookup Rate	Age 63	Age 68	Age 73	Age 78	Age 83	Age 88
2.81%	5.000%	0%	0%	0%	0%	0%	0%
2.94%	5.125%	-3%	-3%	-3%	-2%	-2%	-2%
3.06%	5.250%	-6%	-6%	-5%	-5%	-4%	-4%
3.19%	5.375%	-9%	-8%	-8%	-7%	-6%	-5%
3.31%	5.500%	-12%	-11%	-10%	-9%	-8%	-7%
3.44%	5.625%	-15%	-14%	-13%	-12%	-10%	-9%
3.56%	5.750%	-18%	-17%	-16%	-14%	-12%	-11%
3.69%	5.875%	-21%	-20%	-18%	-16%	-15%	-12%
3.81%	6.000%	-24%	-22%	-21%	-19%	-17%	-14%
3.94%	6.125%	-26%	-24%	-22%	-20%	-18%	-16%
4.06%	6.250%	-28%	-26%	-24%	-22%	-20%	-17%
4.19%	6.375%	-30%	-28%	-26%	-24%	-21%	-18%
4.31%	6.500%	-32%	-30%	-28%	-25%	-22%	-19%
4.44%	6.625%	-34%	-32%	-29%	-27%	-24%	-21%
4.56%	6.750%	-36%	-34%	-31%	-28%	-25%	-22%
4.69%	6.875%	-38%	-36%	-33%	-30%	-27%	-23%
4.81%	7.000%	-40%	-38%	-35%	-32%	-28%	-24%
4.94%	7.125%	-42%	-39%	-36%	-33%	-29%	-25%
5.06%	7.250%	-43%	-41%	-38%	-34%	-31%	-26%
5.19%	7.375%	-45%	-42%	-39%	-36%	-32%	-28%
5.31%	7.500%	-47%	-44%	-41%	-37%	-33%	-29%
5.44%	7.625%	-49%	-46%	-42%	-38%	-34%	-30%
5.56%	7.750%	-51%	-47%	-44%	-40%	-36%	-31%
5.69%	7.875%	-52%	-49%	-45%	-41%	-37%	-32%
5.81%	8.000%	-54%	-51%	-47%	-43%	-38%	-33%
5.94%	8.125%	-55%	-52%	-48%	-44%	-39%	-34%
6.06%	8.250%	-57%	-53%	-49%	-45%	-40%	-35%
6.19%	8.375%	-58%	-55%	-51%	-46%	-42%	-36%
6.31%	8.500%	-60%	-56%	-52%	-48%	-43%	-37%
6.44%	8.625%	-61%	-57%	-53%	-49%	-44%	-39%
6.56%	8.750%	-62%	-59%	-55%	-50%	-45%	-40%
6.69%	8.875%	-64%	-60%	-56%	-51%	-46%	-41%
6.81%	9.000%	-65%	-62%	-57%	-53%	-47%	-42%
6.94%	9.125%	-66%	-63%	-58%	-54%	-48%	-43%
7.06%	9.250%	-68%	-64%	-60%	-55%	-49%	-44%
7.19%	9.375%	-69%	-65%	-61%	-56%	-50%	-45%
7.31%	9.500%	-70%	-66%	-62%	-57%	-51%	-46%
7.44%	9.625%	-71%	-67%	-63%	-58%	-52%	-47%